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Article

Indonesian Financial Development

——From Government Intervention to Liberalization*——

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I Introduction

The Indonesian monetary system and policies have undergone at least two noticeable changes in the past two decades. The first major change took place in the late 1960s in conjunction with the so-called 'New Order' of the President Soeharto. The second drastic revolution appeared in the early 1980s. This was perhaps regarded as a necessary step to mobilize underutilized resources and to expand financial roles when the Indonesian real sector fell into a downturn. To be sure, these changes seem to have worked as evolving factors at each developing stage, but full-blown monetary development has yet to be realized.

After having experienced devastating inflation throughout the 1960s, the Indonesian monetary authorities primarily sought two monetary goals, one immediate and the other longer term. The first and relatively more important objective was to reestablish monetary stability. It is accurate to stress that this goal was very urgently needed to attain political and social stability. Some records indicate, an average of almost two hundred percent annual inflation prevailed in the 1960s prior to the official establishment of the current Soeharto regime. This high inflation was considered partly a result of a failure or lack of monetary policy.[1] The average growth rate of money supply was increasing more than one hundred percent per annum during that period. The monetary authorities attempted to reduce the money growth

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1) As widely known, this was to a greater extent induced by an expansive monetary policy due to fiscal sector domination.

to a more orderly magnitude.

An orderly money market and price stability were in fact parallel to the stability of the rupiah exchange rate. Since the Soeharto government adopted a policy of no foreign exchange control, the overvalued rupiah eventually created an environment of a massive capital outflow. Therefore, whenever disequilibrium of exchange rates was perceived, it triggered a disorderly money market in Indonesia. It was known that there could be no practical and effective way to enforce foreign exchange control in an archipelago nation like Indonesia. Thus, an economically realistic exchange rate became crucial for monetary policy consideration, too. Essentially, a stable money market had to be attained first and foremost. In October 1968, the rupiah exchange rate was realigned to 326 rupiah per one US dollar. This new fixed exchange rate was expected to be sufficient to offset disequilibrium and therefore it was widely hoped that this rate could be maintained for a long period since the new exchange rate was approximately a one hundred percent below the average level of 1967.

The second goal was to diffuse the 'monetary' transactions in a wider range of the economy. The so-called monetization process is known to possess various positive implications for economic development. As Patrick [1966] and Gurley and Shaw [1967] stated theoretically, financial development serves to promote more efficient resource allocation and investment, which thus leads effectively to the accumulation of the real capital stock. The Indonesian financial situation was underdeveloped in this regard. This was partly due to the result of the less active policy, and also because of geographical diversity. To attain this goal, the monetary authorities had to deal with many immediate, but difficult tasks : for example, restructuring the monetary system, modernizing every financial institution and educating all classes of people to materialize benefits generated from the monetized economy.[2)]

As an economy advances, it is likely that it experiences more rapid growth in financial assets than in national output. There are three major reasons for secularly rising financial ratios as pointed out by Gurley and Shaw [1967]. First, division of labor in production that involves exchange of factor services and outputs implies lending and borrowing. The diseconomies of finance-in-kind induce monetization. Second, finance is associated with a division of labor between saving and investment. During the development process, the division of labor between saving and investment becomes more intricate, and this institutional evolution usually precipitates more rapid accumulation of financial assets than of real wealth. Third, growth in both quantity and variety of financial assets can be further promoted.

Nevertheless, it would be wise to evaluate the monetization process cautiously if looking at only a single ratio of a monetized component to some aggregate economic indicator. That monetization process

2) The role of monetary economics in developing countries is briefly summarized in, for example, Ghatak [1981].

is essentially a dynamic historical process and is not a conscious objective of policy in most developing countries, as stated by Chandavarkar [1977]. Such a process must involve a variety of changes in the sectoral and regional levels over time in a diversified economy. In the past fifteen years, for example, it is widely reported that the proportion of transactions-in-kind in Indonesia has diminished considerably, even on remote islands. A single monetization ratio probably does not reflect such changes in those regions in an appropriate manner. However, data limitations generally prevent proper examination of the monetizing process in a developing country in detail. It should be noted that the following section serves to illustrate only one indication of the evolution in the Indonesian monetary sector.

A time series of monetization indicators in Indonesia can be seen in Table 1. The most significant increase relative to the national output is seen in the 1980s. In fact, between 1969 and 1984, the total deposits at deposit banks grew almost one hundred times larger. Such an enormous increase in the demand for various deposits seem to be the result not only of policy encouragement, but also of the evolving process of monetization during this time period. The former contribution to the monetization process will be discussed in the later part of this section. The table suggests that the monetary sector in Indonesia gained momentum, even though its current stage might be still classified premature. Monetizing development in the early 1970s must have had a very positive effect on the Indonesian economic development.

Table 1 Selected Financial Indicators of Monetization in Indonesia

	Ratio of M_1 to GDP (%)	Ratio of M'_2 to GDP[1] (%)	Ratio of Total Deposits to GDP[2] (%)
1969	6.7	8.8	4.2
1970	7.7	10.3	5.1
1971	8.7	12.0	7.2
1972	10.4	14.4	7.7
1973	9.9	14.9	8.4
1974	8.8	12.3	7.2
1975	9.9	15.6	10.4
1976	10.4	17.0	11.8
1977	10.5	16.4	10.9
1978	10.9	16.7	11.0
1979	10.6	16.2	11.1
1980	10.1	16.8	12.0
1981	12.0	17.8	12.9
1982	11.9	18.5	13.5
1983	10.6	20.4	15.7
1984[3]	10.0	20.9	16.5

Notes : 1) M'_2 is defined as the sum of M_1 plus quasi-money, including foreign currency deposits.
2) Total deposits include demand, time and saving deposits plus foreign currency deposits.
3) The GDP figure in 1984 is provisional, which is provided by BAPPENAS.

Source : Bank Indonesia, *Indonesian Financial Statistics*, various issues.

In the subsequent sections, we will examine the policy environment for many monetary actions and their effects on the economy. Section II describes the institutional framework. In Section III, the old monetary policy under the Soeharto era, which was maintained until the early 1980s, is examined. This policy is compared with a series of new financial policies witnessed

since 1983 in Section IV. Final comments are provided in the last section.

II The Indonesian Financial Structure

Rehabilitation and Stabilization Period: Prelude to the First REPELITA

Clearly, the earlier Indonesian financial system was under the strong influence of Dutch control. The independent Indonesian monetary system could not be realized until the nationalization of De Javasch Bank in 1951. The old bank, which was established by the Dutch in 1827, was reinstitutionalized as the fundamental body of the Bank Indonesia. At the same time, more concrete actions were needed to renovate this bank to fulfill the role of central bank in Indonesia. Thus, the government introduced a series of the key laws and guidelines in subsequent years. The Bank Indonesia emerged as the single central bank by statute in July 1953. It was immediately decided that the fundamental monetary policy would be initiated and supervised by the Monetary Board. A limited number of economic ministers and the governor of the central bank were appointed to serve as board members.

Looking back on the 1950s and 1960s from a modern banking perspective, the major monetary policy instrument appears to have been the reserve requirement of 30 percent of all bank deposits. This policy was maintained until 1977 without any revision. Since there were essentially no other visibly significant financial markets in Indonesia, commercial banking remained the only formal monetary system. These banks were not sufficiently developed in many aspects. This situation caused the central bank constantly to face possible liquidity problems which could have easily triggered a serious monetary crisis. Such a situation might be easily exacerbated by the shallow banking structure. Thus, the seemingly high ratio of required reserve position was strictly enforced, though it was not in fact the central policy instrument for the BI.

Although the Bank Indonesia was in charge of the central banking role such as supervising banking, its relatively more important roles were found in other areas. The Bank Indonesia provided a large proportion of credits directly to the final demanders. This implies that this bank behaved in the money market as if it was a single largest and active commercial bank. Furthermore, Bank Indonesia lent increasingly excessive money to the central government. In other words, this central bank was recognized as a vital source of the central government budgets. This "printing money policy" eventually led the money market to a textbook case of hyperinflation in the early 1960s.[3)]

Substantial modernization of the banking system is said to have started in 1967 under the current political regime. In that year, Basic Banking Law No. 14 was introduced and the formal banking structure was rearranged into three types of banks

3) The causes and effects of the Indonesian hyperinflation were examined by Aghevli and Khan [1977]. Also, Nasution [1983] describes thoroughly the underlying economic conditions.

other than the Bank Indonesia: commercial banks, savings banks and development banks. At the same time, the Central Bank Act of 1967 and 1968 were newly enforced and its role was more strictly and clearly defined than the earlier body of the Bank Indonesia Act. For example, the Bank Indonesia previously could serve as a commercial bank, as already pointed out. Hereafter, its traditional commercial banking functions were transferred to other state-owned commercial banks.

While structural rehabilitation was attempted, a drastic organizational change in the monetary policy formation was programmed. All economic policies, of which monetary policy was a subset, came to be managed and decided by the new Economic Stabilization Council, in which the President serves as chairman. The role of the Monetary Board under the new law was thus redefined to assist the higher council and to implement the government's monetary policy in a coordinated manner. In this sense, the degree of autonomy of the Bank Indonesia was rather restricted. However, the Bank Indonesia was released from the burden of the fiscal deficit financing. It was recognized that the major cause of inflation in the early 1960s was the government budget deficits. Fiscal discipline was an urgent task for the new regime. Concurrently, a balanced budget policy and quarterly budget programmes in each fiscal year were introduced. This was the most important achievement under the new political regime effecting economic stabilization in the later 1960s.

Throughout this stabilization and rehabilitation period, the banking system was restructured on the basis of the classified business area of each state-owned commercial bank and other banks. Still, the principle policy instrument was inherited from the previous system: namely, administered interest rates policy with particular attention to loan rates. This policy, widely-known as credit rationing, was actively used to allocate scarce credits to preferential projects or priority sectors for the governmental objectives.[4] In the subsequent years, the government repeatedly had to adjust interest and rediscount rates to attain its goals. Similar tight control was introduced for the foreign debt cases in accordance with the establishment of the IGGI.[5] After having recognized an almost insolvent position externally in the middle of the 1960s, the government decided to strengthen its control and surveillance of foreign borrowing and its underlying terms and conditions. Implied in this action is a drastic change in the government stance toward foreign aid. The government decided to increase the share of foreign credits for financing development projects, rather than for commodities imports such as rice and other necessities.

The rupiah exchange rate was immediately realigned. The government then at-

4) The issue of credit rationing is popular among developing countries. Indonesia was not exceptional until 1983. The essential message of this policy is described in, for example, Johnson [1974].

5) Inter-Governmental Group on Indonesia is composed of major industrial countries.

tempted to simplify the foreign exchange system from the previous multiple exchange rate mechanism [Thasan 1966].

Throughout this gestation period, the Indonesian monetary system, mostly the banking sector, systematically reorganized. In the following subsection, the structure of the contemporary Indonesian financial system will be explained briefly.

The Structure of the Present Indonesian Banking System

The Indonesian financial system presently consists of the Central Bank, deposit money banks and other non-bank financial institutions. The last group includes investment finance, development finance, instrument trust, housing finance, insurance and leasing companies.

The activities of Bank Indonesia, commercial banks, and other banks are regulated by corresponding laws. These include the Act No. 14 of 1967 on banking principles and the Act No. 13 of 1968 on the Central Bank. Meanwhile, non-bank financial institutions, some of which were observed as early as 1972, are currently governed and supervised under special decrees.

In the formal banking sector, commercial

Table 2 Relative Share of Outstanding Bank Credits by Groups of Banks[1)]

(%)

	Bank Indonesia[2)]	State Owned Banks	National Private Banks	Regional Development Banks	Foreign Banks	Total
1969	35.7	56.1	7.0		1.2	100.0
1970	26.8	64.4	6.9		2.2	100.0
1971	21.0	69.3	6.7		3.2	100.0
1972	19.3	70.1	6.7		4.0	100.0
1973	15.4	72.8	6.7		5.1	100.0
1974	16.8	72.5	6.3		4.6	100.0
1975	32.5	58.3	3.9	1.0	4.4	100.0
1976	34.0	56.3	4.5	1.1	4.2	100.0
1977	31.2	57.6	5.2	1.3	4.7	100.0
1978	35.9	52.5	5.5	1.2	4.9	100.0
1979	34.5	52.2	6.5	1.4	5.5	100.0
1980	31.1	54.6	7.2	1.8	5.3	100.0
1981	26.1	57.9	8.2	2.4	5.4	100.0
1982	21.3	61.7	9.2	2.7	5.1	100.0
1983	15.4	64.0	12.3	2.7	5.6	100.0
1984	4.6	70.9	16.2	2.7	5.6	100.0

Note : 1) Sum of shares in each year does not necessarily add up to 100.0 due to rounding.
2) Bank Indonesia credits to non-financial sector and non-central government.

Source : See Table 1.

banks constitute the largest operating banking entities in the country. This group consists of five state-owned commercial banks, ten private national foreign exchange banks, sixty-nine private national banks and eleven foreign banks. There are also twenty-eight development banks, including one private, one national and twenty-six regional government-owned banks. These are assigned to grant long-term investment credit. Two savings banks are engaged in facilitating the mobilization of savings.

In 1973 and 1974 three development finance companies and nine investment finance companies were established in Indonesia. Also, PT Sarana Bersama Pembiayaan Indonesia, a housing finance company, was established in June 1981. This represents Indonesian participation in the ASEAN Finance Corporation. The other financial institutions include ninety-three insurance companies, sixty-eight leasing companies and a number of other institutions of lesser significance such as pawn shops.[6)]

The entire financial system in Indonesia has developed considerably and other various types of financial services have become increasingly available. There is no doubt that this trend has helped to increase the people's welfare. Nevertheless, the dominant portion of the whole financial system is still occupied by the banking system. In this regard, it seems very important to know the basic functions of each group of banks, including the Bank Indonesia. The relative importance of these banks is roughly represented in the relative share of outstanding bank credits in Table 2.

III Development Strategy and Monetary Policy Implementation

Major Monetary Policies Held until the Reverse Oil Shock in 1983

Monetary authorities have been cautious in controlling money supply. This has been favorably assessed by many observers recently, primarily because of its success in reducing inflationary pressure. At the same time, it has been critically pointed out that Indonesian monetary policy has created some serious difficulties for balanced development within the financial framework. Immediately after the authorities recognized the drawbacks of the existing monetary conditions which were mostly induced by the basic economic policy, a new policy was introduced in 1983. An examination of the new policy will be made in the next section. In this section the former policies are discussed.

Since 1969, the monetary authorities have strengthened two instruments for monetary policy, namely, credit control through Bank Indonesia, and interest rates restrictions on loans and deposits through the state-owned and regional development banks. In order to place the money supply under central bank control to some extent, the authorities considered it necessary to administer financial price and quantity controls. Since available credits were recognized to be quite limited, the government assumed that credit rationing was needed

6) Those numbers are as of August of 1986.

Table 3 Bank Indonesia Assets

(Billion Rupiahs)

	Foreign Assets	Domestic Assets					Total Assets
	Total	Total	Credits to Central Gov't	Credits to Public Enterprises	Credits to Deposit Money Banks	Others	
1969	66	351	104	78	80	89	417
1970	83	442	102	87	111	142	525
1971	85	500	134	86	144	136	585
1972	252	423	95	111	149	68	675
1973	384	517	104	148	194	71	865
1974	611	703	91	227	294	91	1,314
1975	291	1,994	434	905	565	90	2,285
1976	655	2,348	313	1,239	640	156	3,003
1977	1,052	2,485	388	1,227	682	188	3,537
1978	1,655	3,713	615	1,937	846	315	5,368
1979	2,636	4,414	736	2,143	1,129	406	7,050
1980	4,360	5,445	799	2,414	1,722	510	9,805
1981	4,121	6,946	1,084	2,583	2,547	732	11,067
1982	3,730	9,977	1,293	2,668	3,742	2,274	13,707
1983	6,433	10,307	701	2,230	4,365	3,011	16,740
1984	9,169	12,449	729	720	6,938	4,062	21,618

Source : See Table 1.

to promote effective economic development. Throughout the period of the first three REPELITAs, an import substitution policy was essentially pursued.[7] The credit rationing policy was consistent with such a development strategy.

The central bank was quite active in performing these policies. As an inevitable consequence, the existence and growth of state-owned banks became increasingly emphasized. As Table 3 shows, among the domestic assets of the Bank Indonesia's balance sheets, credits to deposit money banks, mostly supplied to the state banks, became increasingly significant. That credit supply trend was quite visible in its balance sheets. In 1975, the so-called Pertamina incident became public. Since then, the central bank served to provide credits directly to public enterprises and projects in the REPELITA II years, as seen in Table 3. Although the pace of credit supply to those sectors declined during the REPELITA III, the size of credits still far exceeded a level of two trillion rupiahs until 1983.

The Bank Indonesia credits were largely limited to supplying intended sectors or industries, as briefly shown in Table 4. The changes in the size of those credits reflect the varying policy emphasis of the government from year to year. For example, the agricultural sector was, as widely

7) REPELITA is a five year economic plan and the first one started in 1969. The third one ended in March 1984.

Table 4 Bank Indonesia Credit Supply

(Billion Rupiahs)

	Credits to Bank				Direct Credits			Total
	Total	Agiriculture & Primary Products Sector[1)]	Investment Credits	Manufacturing Industry	Total	Mining	Trade	
1969	80	60	6	3	87	0	72	167
1970	113	67	26	6	97	0	62	210
1971	143	67	56	3	104	0	60	247
1972	150	63	73	2	127	0	89	278
1973	195	108	73	3	155	0	118	349
1974	294	181	82	4	235	0	193	529
1975	565	321	88	106	894	726	143	1,459
1976	640	372	122	90	1,212	1,020	167	1,852
1977	682	322	183	123	1,229	1,042	176	1,911
1978	846	414	173	169	1,935	1,679	238	2,781
1979	1,129	419	277	278	2,163	1,875	248	3,292
1980	1,722	418	419	449	2,454	1,849	507	4,176
1981	2,548	535	829	625	2,649	1,644	809	5,197
1982	3,742	908	1,226	688	2,771	1,402	994	6,513
1983	4,365	801	1,685	695	2,356	720	1,110	6,721
1984	6,938	2,320[2)]	2,165	819	870	169	—	7,808

Notes : 1) This includes items such as sugar, estate, agriculture, export, cotton and wheat, as appeared in Table 2d. in IFS.

2) The figure includes credits for food stock.

Source : See Table 1.

recognized, continuously stressed as a central sector for the development. Therefore this sector steadily obtained large credits from Bank Indonesia. On the other hand, the sudden increase of credits to the manufacturing industry observed during REPELITA II and III show the government's commitment to industrial projects. Those credits, for example, were provided first to Bank Dagang Negara to finance, for example, PT Krakatau Steel.[8)] Direct credits to mining sector similarly reflected the PERTAMINA borrowings.

While the Bank Indonesia's direct credits increased visibly, the sources of credits from the deposit money banks showed significant changes. Various deposits gained shares over the period, as shown in Table 5. Since 1975, the relative share of all deposits in total liabilities exceeded fifty percent, attributing to the fast increase in time and savings deposits. In many developing economies, one of the most serious constraints on financial development is the lack or shortage of relatively longer

8) Administered credit supply sometimes leads to expensive and inefficient projects. The criticism against development strategy through this kind of policy centers around the issue of inefficiency. The cases of the Indonesian big projects have widely been argued as similar incidents of this problem.

Table 5 Movement of Liability Items of Deposit Money Banks

	Relative Share in Total Liabilities					Volume of Total Liabilities (Billion Rupiahs)
	Demand Deposits (%)	Time and Savings Deposits (%)	Foreign Currency Deposits (%)	Borrowings from Bank Indonesia (%)	Other Liabilities (%)	
1969	20.9	0	20.6	25.3	33.2	277
1970	17.3	0	18.2	26.0	38.5	462
1971	23.4	0	19.1	24.1	33.4	619
1972	17.8	5.4	14.4	16.9	45.5	931
1973	16.3	5.6	17.6	14.2	46.3	1,440
1974	19.4	5.8	12.7	14.8	47.4	2,039
1975	24.0	24.1	5.2	22.2	24.6	2,473
1976	24.8	26.8	5.2	20.4	22.8	3,200
1977	26.6	27.3	3.9	17.6	24.7	3,609
1978	25.1	22.1	5.5	18.1	29.2	4,761
1979	27.6	18.1	10.7	17.9	25.7	6,287
1980	30.0	15.9	12.6	17.6	24.0	9,319
1981	31.7	16.7	9.0	21.4	21.2	12,139
1982	28.2	17.0	9.6	26.5	18.7	14,654
1983	21.8	24.4	11.9	22.2	19.7	19,202
1984	18.9	25.0	11.5	27.6	17.1	25,557

Source : See Table 1.

term deposits which can be available for longer term investment. In this regard, this new development in Indonesia is on the right track.

There are no readily available statistics on the size of different deposits by various types of commercial banks. However, it is widely recognized that the state-owned banks were the dominant recipient of those deposits. This was probably due to the simple fact that many public enterprises and national project entities were required to maintain all deposits with the state-owned banks. Interest rates on deposits at state banks were strictly controlled and monitored by the central bank. The case of twelve month time deposits is summarized in Table 6. The table shows that the central bank rarely changed the rate through the 1970s. Though the interest rates seemed high, the actual cost of holding

Table 6 Time Deposits Interest Rates with State Banks (12 Month Time Deposits)

Date		Monthly Rate (%)	Annual Rate (%)*
1969	July	3	42.6
	September	2.5	34.5
1970	January	2	26.8
1972	May	1.5	19.6
1973	April	1.25	16.1
1974	April	1.50	19.6
	December	1.25	16.1
1977	January	1	12.7
1978	January	3/4	9.4
after 1983 June		Bank determined rate	

* Annual Rate, compounded rate.

Table 7 Lending Interest Rates by Economic Sector

Date, from.		Investment Credits, Medium-term		Export Goods Sector[4]	Manufacturing & Service Rendering Industries	
		Category I[1]	Category IV[2]		Textile	Cement
1972	May	12	12	18	24	24
1973	April	12	12	15	18	18
1974	April	12	15	18	18	21
1974	December	12	15	15	15	18
1976	April	12	15	12	15	18
1978	January	10.5	13.5	12	13.5	13.5
1982	January	10.5	13.5	9[5]	13.5	13.5
1983	June	12	**[3]	9[5]	**[3]	**[3]

Note : 1) Category I : the amount of investment credits up to Rp. 25 million before January 1978. Since then this level has been raised to Rp. 75 million.
2) Category IV : before 1978, the amount above Rp. 300 million. Since then the amount decreased to between Rp. 1,500 million, and above Rp. 500 million.
3) Rate determined by banks.
4) There are differentials among categories in this sector. Thus the lowest rates were adopted.
5) Applied to promising export commodities.

time deposits was likely to be expensive. This is simply because that the depositors were always exposed to the rupiah currency risk. Since the government has maintained the open capital account system, attractive interest rates should have corresponded simultaneously to a stable exchange rate.[9] Nonetheless the exchange rate and interest rate policies seemed not to have been well-integrated in the past.

Interest rates on loans to economic sectors and special activities were similarly programmed by the Bank Indonesia. Table 7 shows only a limited number of cases. Since the government was basically seeking import substitution in industrial sectors, investment credits were supplied to those sectors at relatively lower rates. In addition, relatively smaller-sized investments were favorably treated in terms of interest rates. Since 1978, all activities related to investment, export and manufacturing have been treated almost equally by credit supply institutions. The system of programmed lending rates was continuously managed until May 1983.

In comparing the two tables mentioned above, it becomes obvious that the state banks were in many cases induced to have a negative interest rate margin. To mitigate such an inconsistency, the central bank provided a predetermined interest rate subsidy for each loan made by the state commercial banks. As a result, national and foreign private banks were always placed in a less competitive position. Consequently, the state-owned banks cum Bank Indonesia dominated in terms of the total outstanding credits, as seen in Table 2.

9) Because of this policy, it has been said that there was no illicit currency market in Jakarta.

Until May 1983, the state banks were allowed to have a deposits account abroad. It has been allegated that a considerable amount of the funds of the state-owned banks was invested abroad. The open capital account system is generally not compatible with credit rationing policies. Some private sector elements were induced to borrow relatively expensive funds abroad, since the domestic credits were tightly controlled by the Bank Indonesia. In this regard, the allocation of the domestic scarce resources was distorted.

These financial developments were caused by the government-led growth policy. Due to the two oil price increases, the central government received massive external funds. However, those funds had to be counted as fiscal receipts in a corresponding fiscal year due to the existing regulatory rule. The fiscal sector grew at a great pace. This policy framework itself was prone to be inflationary. Because of fiscal regulation, the government was not permitted to establish an independent account such as the so-called development funds by which the pooled money can be allocated over longer term to realize a stable development process. This possibility was officially restricted. Nevertheless, the central government quietly maintained some portion of funds with the central bank. After the second oil shock in 1979, such stock roughly accounted for one quarter to one third of the central bank's total liabilities. The volume of these deposits, however, was actively hoarded as it was. This savings account had two purposes. The first one was, as mentioned already, to restrain excessive fiscal expenditures. Another purpose was for the government to retain some ability to control the money market. The overall operation of manipulating the government account is generally termed as neutralization policy. In December 1977, for example, the long maintained required reserve ratio of the total liabilities with commercial banks drastically decreased from 30 to 15 percent. The former reserve requirement seemed very burdensome to bankers by any standard. Such a drastic change might have caused an expansion of money supply through the banking system. So the monetary authorities increased deposit stock of the government by more than 50 percent. During the three years following the second oil shock, government deposits increased so as to mitigate the money supply increase. At the same time the Bank Indonesia attempted to reduce other liabilities relatively.

However, those active policies by the government made the central bank decrease the use of common monetary instruments. The central bank was to a greater extent dependent on the government development schemes. It is generally desirable that a central bank be able to perform as an independent monetary institution even in a developing economy. This feature of a central bank is particularly important in order to preserve real currency value. In the case of Indonesia, Bank Indonesia acted frequently as a competitive lender with other commercial banks. As already shown, its share in total outstanding credits was not small each year. The question

is whether the central bank's direct participation in various projects was necessary in the foreseeable future. If the monetary system were still needed as it had been, then the Bank Indonesia would not need to act as the bank for banks. The domination of the fiscal sector and public enterprises in the Indonesian economy did not mean that such a massive number of state-owned banks would remain innovative. Some observers felt that some kind of reform was needed. However, at the same time, they also recognized that a reform of this kind of monetary system was very difficult because those banks had been acting mostly as an agent bank for public projects and enterprises. In regard to credit-rationing measures, the direct operation of the central bank in credit markets had taken away the potential of private financial institutions. The managed system of the Indonesian monetary activities had long functioned because of the injection of enormous amounts of funds earned from exporting oil and oil products into the economy.

Around the middle of 1982, the monetary authorities expressed their concern about the effectiveness of the existing monetary system to enhance future economic development. This issue was also highlighted by the sudden reduction of foreign assets with the Bank Indonesia. The central bank of course held the option of devaluating the rupiah. However, measure was difficult in 1982. Since economic growth had started declining slightly, such an inflationary measure might have hurt the standard of living of the public. Between 1981 and 1982, government deposits therefore could not be increased.

To escape from the reverse oil trap, the enduring system of fiscal and monetary policies were questioned. While the agricultural sector made considerable progress in production, the authorities started to reevaluate whether the financial system grew enough to stimulate, particularly, the stagnant industrial sector. The primary concern was how the reorganized financial system could effectively work both to expand the manufacturing foundation and to promote exports. Weakness of the Indonesian economic structure due to the overwhelming influence of the public sector and excessive reliance on the oil sector. The industrial sector, in which the government spent a considerable amount of money in the past, was not sufficiently capable of exporting their products and could not get strong and stable without official financial support. Under such circumstances, monetary authorities must rigorously seek both to increase efficiency in the monetary system and to mobilize resources, especially in export industries. A new monetary policy was decisively introduced in June 1983.

Factors Affecting Changes in Monetary Supply

It is widely known that the Indonesian money supply was greatly and directly affected by external economic events and often by the structural changes in the financial system. Understanding the anatomy of the money supply, thus, is very important for distinguishing various causes

and effects of money supply changes. Growth goals were often constrained by difficulties with the balance of payments and threatened by pressure on price levels. Whenever an excessive supply of money appeared to stimulate economic activity and promote further monetization, it was likely to lead an almost instant price increase and thus an expected rupiah devaluation. The ramifications of such resulted in the deterioration in the Indonesian BOP. Within such an economic environment, stabilization policy was very difficult. In many instances, monetary stimulation of economic development did not always seem compatible with price stability in Indonesia. The supply of commodities, whether those of necessity or capital goods, was severely constrained. Since the motive of money holding was essentially limited in the transaction purpose as will be examined below and the alternative financial assets were also limited,[10] the failure of the money supply seemed closely linked to the price change.

The monetary authorities seemed to be aware of this sensitive relationship. During the Soeharto era, even though the main thrust of financial policy was the direct control of credits and prices, monetary authorities were carefully monitoring the effect on the level of money supply. Of course, this was not publicly stated as a policy target. But the money supply observed in the past was mostly within tolerable levels even during the period immediately after the two oil shocks. In this sense, it may be appreciated that the monetary authorities did not make light of the firm stabilization policy. In general, the governmental projects and entities are likely to demand excessive credit through the political channels. This is likely to aggravate the money supply increase. However, the Indonesian monetary authorities tended to reduce such pressure, except a few cases such as Pertamina-related projects. The overall credit line was fairly tightly controlled under the discipline.

To view this money supply management, changes in money supply are quantitatively analyzed here, as Bhatia[1971]attempted.[11] The money supply (ΔM) is roughly caused by either behavioral causal factors (ΔM_k) or non-behavioral causal factors (ΔM_L). The former is related to changes in various elements which will eventually result in a change in the money multiplier. The latter can be seen as changes in the

10) The transaction motive of money demand in LDCs is the foundation of the McKinnon model as well as Gurley and Shaw model. See McKinnon [1973], for example.

11) The following is the list of variables used in this section:
- M: narrowly defined money supply, in which currency in circulation and demand deposits are included
- M_k: a portion of money supply which is related to behavioral causal factors
- M_L: a portion of money supply linked to non-behavioral causal factors
- k: money multiplier
- L: central bank liabilities
- M_F: foreign assets owned by the central bank
- M_G: net credits to the government of the central bank
- M_P: central bank's other assets which resulted from policies of the bank

The source of data is described in the note of Table 9.

liabilities of the central bank. Of course, the movement of the liabilities corresponds to changes in the composition of assets of the central bank. Thus sources of money supply change are clarified by examining these two factors.

By the definition, the change in the money supply is summarized as follows:

$$\Delta M = \Delta M_L + \Delta M_k$$

Assuming that money is the sum of currency in circulation and demand deposits, that is, narrowly defined money, the money multiplier (k) is given as:

$$k = \frac{1}{c + r(1-c)}$$

where $c \equiv \frac{C}{M}$ = the ratio currency in circulation to the money stock

and $r \equiv \frac{R}{D}$ = the ration of the reserve to demand deposits.

The ex post money supply is expressed as a product of the central bank's monetary base and the money multiplier. Accordingly, two sources of the money supply change are derived in the following functional forms:

$$\Delta(M_L)_t \cong \Delta L_t \cdot k_{t-1}$$

$$\Delta(M_k)_t \cong L_t \cdot \Delta k_t$$

where L represents the central bank liabilities and t denotes the period of time.

As indicated above, the change in the central bank liabilities is subdivided into changes owing to foreign assets (ΔM_F), net credits to the government (ΔM_G) and others (ΔM_p) which result from various activities of the central bank:

$$\Delta M_L = \Delta M_F + \Delta M_G + \Delta M_p$$

Therefore, the change in money supply is ultimately represented in the equation:

$$\Delta M = \Delta M_F + \Delta M_G + \Delta M_p + \Delta M_k$$

Table 8 describes the time series of money multiplier and its components, for the case of narrow money supply. There are clear tendencies in these indicators in the past years. The money multiplier has been increasing and two components show a gradual decline. These movements generally fit the pattern for a process of financial modernization. The sudden decline in the ratio of reserves to deposits in 1978 reflects the policy change of the reserve require-

Table 8 Currency Ratio (c), Reserve Ratio (r) and Money Multiplier (k)

	c	r	k
1969	.634	.500	1.220
1970	.620	.396	1.278
1971	.620	.413	1.287
1972	.574	.480	1.285
1973	.561	.391	1.365
1974	.527	.564	1.260
1975	.500	.611	1.242
1976	.487	.636	1.230
1977	.488	.607	1.252
1978	.498	.442	1.389
1979	.459	.426	1.450
1980	.431	.372	1.556
1981	.394	.305	1.728
1982	.412	.241	1.806
1983	.440	.352	1.570
1984	.433	.351	1.582
1985	.439	.334	1.597

Note : c=C/M, r=R/D.
C is the amount of currency in circulation and M is the narrowly defined money supply. R is reserve money and D represents demand deposits.

Source : All data are provided by Bank Indonesia and BAPPENAS.

ment ratio reduction from 30 to 15 percent. Another decline of this ratio in 1982 was induced by the readjustment of reserves held by the deposit money banks. Although the central bank has paid interest on the excess reserve held with Bank Indonesia, deposit money banks have always been concerned about a possible devaluation of rupiah value. While observing the reduction of official international reserves since 1981, the deposit money banks tried to minimize their currency risk exposure of excess reserves. It should be noted that the exchange rate system was transformed from the fixed to the managed floating exchange system in 1978.

Money supply change, represented in Table 9, clearly reflects these events. Until the middle of the 1970s, behavioral factors had affected money supply by lowering the money multiplier, although only slightly. This feature was manifested through the close relations between the central bank and the state-owned banks. The central bank's credit rationing closely corresponded to the assets management of these deposit money banks. The drastic change observed in 1983 was simply a result of currency risk avoidance of deposit money banks made in 1982. In this year, the rupiah was devalued by 28 percent. Since then, the multiplier returned to a normal level.

As explained above, non-behavioral factors were mostly induced by exogenous or policy reasons. These sources can be traced by looking at the asset side of central bank balance sheets. Table 10 represents the relative contribution by sources to Bank Indonesia total assets holding. Basically,

Table 9 Money Supply Changes: Behavioral and Non-Behavioral

	M_1	$\Delta HPM_t\ k_{t-1}$	$HPM\Delta k_t$
1969			
1970	100.0	78.1	21.9
1971	100.0	104.3	−4.3
1972	100.0	100.6	−0.6
1973	100.0	78.5	21.5
1974	100.0	127.9	−27.9
1975	100.0	106.0	−6.0
1976	100.0	104.6	−4.6
1977	100.0	91.8	8.2
1978	100.0	46.7	53.3
1979	100.0	84.5	15.5
1980	100.0	77.7	22.3
1981	100.0	57.8	42.2
1982	100.0	46.9	53.1
1983	100.0	353.6	−253.6
1984	100.0	93.3	6.7
1985	100.0	94.1	5.9

Note: The Bank Indonesia data from IFS were used to derive all figures.
Source: See Table 1.

assets composition has been predominantly affected in most years by changes in foreign assets. One can easily identify the rapid increase of foreign assets when the rupiah was devalued in 1971, 1978 and 1983 and similarly when oil export prices were increased in 1973 and 1979. Those increases had considerable magnitude as the table shows. In corresponding years, it is important to recognize the large reduction in the net asset position to the government. This in fact was the increase of the government deposits with the central bank. The overall effect, considering both these changes, was not so large. This deliberate attempt to minimize the external shocks on money supply was the so-called neutralization policy. It was a characteristic

Table 10 Sources of Changes in the Bank Indonesia's Total Assets

(%)

	TA	AF	AG	APE	APR	ABK	AR
1969							
1970	100.0	17.3	9.9	−12.4	19.8	38.3	27.2
1971	100.0	−0.9	76.4	21.8	−24.6	30.0	−2.7
1972	100.0	236.8	−136.8	36.8	5.9	7.4	−50.0
1973	100.0	62.1	−17.7	23.5	1.3	29.4	1.3
1974	100.0	80.8	−31.8	23.3	0	29.2	−1.5
1975	100.0	−93.6	−55.1	169.0	1.3	69.5	7.4
1976	100.0	82.6	−73.3	70.2	1.6	16.6	2.4
1977	100.0	187.6	−82.8	9.0	0	17.6	−31.3
1978	100.0	49.2	−24.5	57.9	1.0	13.7	2.7
1979	100.0	105.1	−68.6	23.5	1.3	30.5	8.2
1980	100.0	151.3	−146.0	25.8	2.3	56.4	10.2
1981	100.0	−27.1	−57.0	25.2	5.8	122.4	30.8
1982	100.0	−13.7	8.8	3.1	2.9	44.6	54.3
1983	100.0	203.1	−164.2	−54.0	0.1	76.8	38.2
1984	100.0	95.7	−71.0	−52.9	1.7	90.1	36.4
1985	100.0	32.9	26.0	1.1	3.5	18.6	18.0

Note : TA : Total assets,
AF : Foreign assets,
AG : Claims on Central Government (Net),
APE : Claims on Public Enterprises,
APR : Claims on Private Sector,
ABK : Claims on Deposit Money Banks,
AR : Others.

Source : See Table 1.

approach made implicitly by monetary authorities. Exceptions are seen in 1975 and 1981. In the first case, the Pertamina incident forced the central bank to increase direct credits to this public enterprise. Thus the reduction in foreign assets was more than offset. In another case, a deterioration of the balance of payments reduced the level of official international reserves. Thus, the increase in the central bank's total assets declined by almost 40 percent relative to the level of the previous year. Since credit supply to deposit money banks increased to almost the same level as before, the relative contribution to the central bank asset composition visibly differred in that year. External shock caused influences which appeared on the Indonesian balance of payments.

Increasing difficulties appeared with the balance of payments after 1982 forced the government to adopt another direct measure. By that time, the policy-makers were probably aware of economic costs of public projects which had been considered the core of high economic growth. If the traditional strategy for growth was maintained, pressure on the balance of payments

would become increasingly intolerable. The government announced a new policy in 1983, in which big projects requiring too much foreign exchange would be frozen. The message of this new governmental decision implied a severe cut in direct credit supply to public enterprises. Simultaneously the monetary authorities introduced a new measure to activate market forces in the money market.

When one examines the history of money supply management in Indonesia until 1983, it can be seen how monetary authorities had to cope with external shocks. The choice of the authorities was often limited to the use of the government account with the central bank. The business with the deposit money banks was probably a less significant instrument for money supply control even though the administered banking system was unquestionable. Policy made in that way by the Bank Indonesia was direct, precise and quick to have the intended effects. The central bank may simply have been reluctant to deal with the shallow banking system and to adjust less significant policy instruments. Obviously, this kind of policy environment is undesirable if the monetary system is to fulfill a substantial role in the economic development and if its base is to be enlarged. In this regard, the old policy and its instruments seemed to have almost reached the limits of their usefulness.

Demand for Money in Indonesia

While monetary assets were willingly held, it is still useful to examine the demand motives of such monetary assets.[12] As Keynesian theory postulates, money is actually demanded as a store of value in addition to its use for transaction purposes. The portfolio demand for money depends on the opportunity costs of holding money. When money is properly defined, the demand function for money can be specified with a limited number of variables. As long as the demand for money is proved to be stable, money supply can be a powerful policy instrument at least in the short run. If money is excessively supplied over the long run, as stated by the quantity theory, a price increase is the sole outcome. This occurred in Indonesia prior to 1969, as mentioned earlier.[13]

The estimated demand for money equation is summarized as follows:

$$\log\frac{M_1}{P} = \underset{(-5.61)}{-8.781} + \underset{(6.83)}{1.281}\log(y) \underset{(2.08)}{-0.188}\log(x) + \underset{(2.61)}{0.206}\log(T)$$

$$R^2=0.984,\ DW=1.591,\ SSR=0.0544,\ 1959\text{-}1983$$

and

$$\log\frac{M'}{P} = \underset{(-6.65)}{-9.264} + \underset{(8.17)}{1.363}\log(y) \underset{(2.70)}{-0.201}\log(x) + \underset{(3.87)}{0.272}\log(T)$$

$$R^2=0.992,\ DW=2.158,\ SSR=0.0431,\ 1969\text{-}1983$$

where M_1 and M' are defined as narrow

12) There are many documents concerning the importance of the demand for money. Laidler [1969] and Johnson [1972], for example, are useful materials in explaining theoretically and empirically relevant issues. The empirical test for the case of Indonesia is attempted by Boediono [1985].

13) See Grenville [1981], in particular, pp. 107–110.

and broad money, respectively. The latter includes quasi-money as defined in the Monetary Survey by the IMF. P is the consumer price index. Real income, proxied by real GDP in 1973 prices, is represented by y. T represents the time trend. This variable is necessary to describe the continuing monetization process. Since we define monetization as a process of diffusion of money holding, it is hypothesized to increase with time. Time trend is therefore expected to capture this process. The interest rate of alternative financial assets is usually considered as an opportunity cost of holding money. Since there have not existed any significant capital markets in Indonesia, an appropriate variable is not readily available. However, one should not disregard that the Indonesian government has been employing an open capital account policy. This means that the residents have not been restricted in transfering funds abroad. The major determinant of capital outflow seems to have been the rupiah currency and political risk prospects. It is difficult to know the degree to which the exchange rate is overvalued. For our purposes, it is assumed that the real exchange rate differential between the relative inflation rates in Indonesia (P_t) and the world (PW_t) represents approximately the degree of under- (or over-) valuation of the rupiah. To construct a simple index, the current real exchange rate is deflated by the exchange rate of 1969, so that this measure,

$$X_t = \frac{RFEX_t}{PFEX_{1969}} \Big/ \frac{P_t}{PW_t}$$

is obtained.

Both equations fit data well, and all coefficients possess the expected sign. It is found that the exchange rate variable, whether it is overvalued or not, plays a key role for the portfolio motive in determining the money demand. Also, the process of monetization is statistically significant within the range of observations. It is shown as an increase in the money demand not along with the motives theoretically postulated, but along with time elapsed.

The coefficient of real income exceeds unity in both cases by which elastic demand for transaction motives is implied. There are some other empirical studies in which income elasticities were similarly reported.[14] Nevertheless, the interpretation of this coefficient may be rather difficult since there is little theoretical reason for money to be treated as a luxury commodity. In Indonesia, there remains the question of what proportion of economic activities is covered by recorded monetary income. It is suspected, for example, that a fairly large amount in the service sector has not been well-documented in income data. Rather, it is evident that the unrecorded portion has played a key role in absorbing the unduly large labor force. In addition, it is noteworthy that the unmonetized sector may remain considerably large. Thus, recorded income may underestimate actual economic activities in Indonesia. Nonetheless, the supply and demand for money suggest that during the relatively low inflation period in the past, Indonesian

14) For example, see Boediono [1985], Table 4 on p. 91.

monetary conditions have progressed in a stable manner. The time trend, which represents one measure of the pace of monetization process, has a positive figure and is statistically significant at the 5 percent level. The important motive of the money demand in Indonesia is a cost of speculative motive in terms of the relative price of rupiah. Whenever the rupiah was thought overvalued relative to other currencies, pressure on the exchange rate appeared since there were limited domestic hedging instruments against such a shock. The way to protect the real value of financial wealth was to switch to other currencies, most often to the US dollar.[15] The estimated elasticity coefficients in both cases are approximately −0.2 and statistically significant at the 5 percent level. This implies that expectation of rupiah devaluation has been one of the key variables to explain the Indonesian demand for money.

IV New Financial Development Since 1983

Aims of Policy Changes and Immediate Results

The official explanation of the June 1, 1983 Monetary Policy was to encourage banks to maximize the mobilization of their funds from the public and thereby reduce their dependence on the central bank for low cost funds in their lending activities. This objective seemed to correspond well with both short run and long run policy considerations.

In the short run, Indonesia had to reform its monetary system to incorporate more competitive factors. As pointed out, the monetary system, which was dominated by state-owned banks, was inherently induced by the various controls of the monetary authorities. The interest rate ceiling did not seem to be effective in promoting investment, especially, in the private sector since credits had been limited. Consequently, the central bank was forced to allocate funds among programs which were often not chosen on the basis of efficiency. Once those programs were officially acknowledged, it was common for them to have been preserved at considerable economic cost.[16] The state banks had established a channel with Bank Indonesia to receive large credits,mounting inefficiency which could not be easily eliminated. In addition, those institutions were not prohibited access to external financial markets. Thus those institutions were enabled to utilize this portfolio option. This suggests that state-owned banks could have

15) An interesting analysis is presented to explain the development and expansion of the Jakarta Dollar market by Arndt and Njoman [1982]. They stated correctly that this new phenomenon would serve to increase the economic well-being in Indonesia. This is because the market would encourage much wider activities of this kind to create domestic rather than foreign hedging opportunities for Indonesian residents.

16) Interest rates ceilings are quite popular in developing countries in recent economic studies. Many economists point out that the cost of financial repression, which is mostly due to the limited scope of interest rate adjustment, should not be underestimated. Fry [1980], Khatkhate [1980], Roe [1982] and Tybout [1983] are some of representative studies recently reported.

an opportunity for handsome earnings abroad. It may not be unrealistic to say that this type of vicious circle could only have probably survived because of abundant oil earnings in the central government. To break up those linkages, the policy makers had to change their basic policy stance. In particular, guided resource allocation needed to be questioned. In a similar vein, the monetary authorities considered whether to abandon the credit rationing policy and the interest rate ceiling. In the early 1980s, this change was imminent. By that time, it was widely speculated that oil earnings would not be so promising in the future.

If the interest rate ceiling were to be dismantled the depositors would be expected to become better-off. Competitive interest rates should reflect all sorts of information on a wide spectrum of economic activities. Thus, when liquidity becomes low enough, interest rates should be adjusted upward. This means that whenever the rupiah is expected to depreciate, the rise in the rate of interest would help protect depositors from the currency risk. Depositors therefore could face a proper set of choices between real goods or monetary assets, even though capital market in Indonesia is not well developed. Contrary to what financial repressionists assert, once the money market is greatly liberated, the public can shift their expenditure from goods consumption to savings. Of course, the Indonesian monetized sector is small. Nevertheless, the learning process may not be limited, but rather it may enlarge the economic basis. In addition to the on-going monetization in Indonesia as evident in Table 1, the financial institutions can have a greater degree of freedom to mobilize funds. A liberalized monetary system, even though it may be partial, can be useful to enhance total efficiency in the economy.

In the long run, the Indonesian economy must inevitably change its structure. This structural change includes, at least, two aspects. One is to encourage private sector production. Because of the high economic growth goal, the government has stressed direct intervention in the market. Thus, this development seems to be hampered by the basic economic approach. There is an obvious reason for which the public sector cannot grow with the past speed: Oil revenues will not continue to be large. There are many theories to support this dismal but realistic prediction. Additionally, even though government spending would be an easy way to raise the growth rate, many technocrats have recognized that this policy creates an excessive economic cost which is difficult to compensate with other policy measures. So long as the government intends to pursue the growth goal, the expansion of the private industrial sector is necessary. As widely discussed among policy-makers, the private industrial base is seriously underdeveloped. Whether it is liked or not, an industrial policy for long-term consideration may be worth studying, as Japan, Korea and other Asian NICs have become quite successful in such a way. In this regard, future success will depend directly or indirectly on the size of the

newly mobilized funds. It is essential that capital flows into the private manufacturing industries. It is also felt that these sectors are the capable of absorbing the massive labor force.[17)]

The second aspect of the long run approach is related to the Indonesian balance of payments. Import substitution has not yet contributed a great deal to the balance of payments. On the contrary, that policy actually required a lot of expensive capital equipment.[18)] Obviously, this policy can contribute to the growth without aggravating the balance of payments only if the value of oil exports remains promising. As far as the future course of economic development is concerned, Indonesia must become less and less dependent on the oil sector. President Soeharto's remark on the 'take-off' may assume this point in which the Indonesian balance of payments should not be significantly affected by the conditions of the world oil market. In this sense, Indonesia must rely increasingly on the exportable industries in the next decade or so. The previous monetary system and policy were not consistent witha such a change. If these policies had not changed, the economic situation of the Indonesian economy would probably be impaired.

The newly introduced reform is along these lines and has been accepted as a step in the right direction. There are three specific changes in the new policy: first, state-owned banks can freely set their deposit rates on all maturities, except for the small savings program; second, credit ceilings are abolished for all banks; third, the number of programs qualifying for new Bank Indonesia credits are minimized. Immediately after these changes, an enormous increase in volume of time deposits was observed, for example, with state banks. Table 11 shows monthly data from 1983. Clearly, the effect of policy change appeared instantaneously. In six months after the new policy, time deposits expanded by more than 130 percent. Due to the change in monetary policy, a slight decline in the dominance of state banks has been observed, as evident from Table 12. Even though the immediate increase in time deposits was favorably welcomed, some serious problems remain unanswered. After the reform, deposit rates have stayed relatively high. The official explanation was that domestic interest rates should now be determined by the market. However, the real rate of interest in Indonesia, after adjusting the ex-post consumer price index, has been far exceeding the international level. One possible reason for this is that there has been constant uncertainty about the rupiah value. Domestic monetary reform may not be

17) The current economic plan was in part created in the belief that five percent economic growth is needed to mitigate the labor force pressure on the market. And it is obvious that in that goal the manufacturing sector must play a leading role. See also the next section for more explantion.

18) In general, it is known that the cost of import substitution will become far excessive. In this regard, export promotion versus import substitution must be carefully examined for the case of Indonesia. This study cannot deal thoroughly with this topic because of its limited scope. For further discussion, see, for example, Krueger [1978].

Table 11 The Immediate Effect of the New Policy in June 1983 on Time Deposits with State Banks and Selected Deposits Interest Rates

	Time Deposits (in Billion Rupiah)				Interest Rates (in % p.a.)[2]	
	3 Month Deposits[1]	6 Month Deposits	12 Month Deposits	Total Time Deposits	3 Month Deposits	12 Month Deposits
1983						
January	3.4	12.2	39.1	911.8		
February	3.4	11.4	40.1	904.7		
March	3.6	11.6	42.3	905.8	9.6	9.6
April	3.3	11.2	42.6	895.9		
May	8.1	26.9	41.2	911.8		
June	129.6	119.3	111.9	1,124.0	16.5	16.5
July	200.0	142.8	217.9	1,287.1		
August	262.7	200.3	352.7	1,500.0		
September	297.7	210.4	417.0	1,581.7	16.2	16.6
October	390.5	327.4	480.3	1,830.4		
November	465.8	344.5	683.6	2,094.9		
December	449.1	298.6	837.9	2,125.8	15.7	17.4

Note : 1) Less than 3 month deposits are also included.
2) Those rates are some sample interest rates with an unspecified state bank.
Source : Bank Indonesia, *Weekly Report.*

Table 12 The Share of Group of Banks in Total Assets and Loans in the 1980s

Group of Banks	Assets or Loans	March 1980	March 1981	March 1982	March 1983	March 1984
State Banks	Assets	79.0	79.8	79.6	77.0	74.8
	Loans	80.1	78.9	78.5	78.4	74.4
National Private Banks	Assets	8.9	9.4	9.9	11.2	13.9
	Loans	9.9	10.7	11.0	11.9	15.5
Regional Development Banks	Assets	3.5	3.9	3.6	3.2	3.5
	Loans	2.1	2.8	3.2	3.2	3.1
Foreign Banks	Assets	8.6	6.9	6.9	8.6	7.8
	Loans	7.9	7.6	7.3	6.5	7.0
Total	Assets	100.0	100.0	100.0	100.0	100.0
	Loans	100.0	100.0	100.0	100.0	100.0

Source : Bank Indonesia, Report for the Financial Year, 1980/81, 1981/82 and 1983/84.

sufficient to eliminate this kind of market uncertainty. Another explanation is that more time is needed to realize a desirable condition in the money market, thus present conditions may be transitory. Otherwise, this high real rate may reflect a high return in a real sector, as neoclassical growth theory predicts, since the Indonesian economic growth has not been so bad compared with many other developing countries.

At the same time, the spread between deposit and borrowing rates was frequently noted to be substantially large even after the reform. Since borrowing rates were not openly available, it is difficult to make a definitive conclusion. However, there is strong reason to believe this view. Due to deregulation, banks tended to prefer adjustable rates when extending credits. A growing proportion of credits has been made on this adjustable system. This tends to increase interest rate volatility and thus to raise borrowing risk. Banks have now become more cautious in providing further credits to existing and potential borrowers. The thinner the market spread is, more efficient the financial market is, as typically exemplified by the Euromoney market. In this regard, the Indonesian money market needs to be further improved.

In addition to this market uncertainty, the realized and maintained high deposit rates may be explained as follows. The sudden reform in the monetary policy induced the Bank Indonesia to restrain liquidity credits. State banks, in particular, experienced a severe shortage. Prior to the reform, state banks were the main suppliers of funds to the interbank market because they had excessive reserve. The source of excess reserves was the Bank Indonesia liquidity credits. Thus, the new development in the money market reversed the situation for state banks. All banks, not just state banks, had to compete in attracting deposits. At least, in the first year after June 1983, the competition was fierce and a dramatic effect on time deposits was observed. Effects on savings and certificate of deposits (CDs) were of a lesser magnitude since not all banks were permitted to participate in these areas.

Meanwhile, strong credit demand continued despite the economic slowdown. The leading borrowers were state-enterprises such as Pertamina, Krakatau Steel and Bulog. The strong demand eventually supported the high rates of interest which were established immediately after the reform.

In September 1984, a minor money market crisis occurred.[19] The interbank money rate suddenly increased to an unacceptable level of 90 percent. Even though the crisis was temporary, the incident gave a message to the market and monetary authorities. It revealed a weak aspect of the Indonesian money market. Some commented critically about the ability of the central bank's crisis management and ineffective supervisory services to marginal banks. Essentially, the crisis was caused by a serious shortage of

19) Nasution [1985] also explains the economic background of this disturbance. See his article, especially, on pp. 20–21.

rupiah liquidity. Without the Bank Indonesia credit facilities, there was no alternative source of financing. The central bank encouraged use of the interbank market. So this single shock, probably from a widespread rupiah devaluation rumor, impinged on the money market, then spectacular pressure appeared in the interbank money market. This incident clearly demonstrated that the central bank need to facilitate more practical instruments in the financial sector.

Follow-up Policy Measures

A sweeping reformation of government economic policy thought occurred before the fourth REPELITA. Although the overall revision in government development strategy was not explicitly announced, a departure from import substitution was, at least, taken into account. Otherwise, the relative share of the public sector in the whole economy would have continuously been growing at the expense of the export sector. By the end of 1983, it looked almost certain that the world economy would remain slow. Indonesian exports, oil and others, seemed likely to be less promising unless drastic policy measures were employed. Therefore, a change in the policy seemed inevitable for the sake of the balance of payments and continued economic growth. Sustained economic growth is the goal for the next five years. This goal may be difficult to achieve without an enlarged industrial base and the promotion of the non-oil export sector. The ambitious plan, five percent growth target through 1989, was announced and became effective in 1984.

The monetary authorities can no longer use direct intervention in credit supply. They have to create alternative policy instruments. Indirect measures have been studied. Even though high economic growth was stressed in the plan, price stability is also equally emphasized because of social and political considerations. This means that money supply will need to be restrained within a tolerable level. As pointed out in an earlier section, there seems to have existed a clear relationship between inflation and money supply in the past. The central bank's concern now shifted, though not completely, from credit supply to discrete 'monetary' policy, because the implementing function of liquidity supply moved from Bank Indonesia to other banks. In this sense, the central bank entered into a new era of policy operation.

To fulfill this new requirement, the Bank Indonesia announced two types of rediscount facilities in February 1984. The first one is the installation of the rediscount window. This serves to assist all banks, both state and non-state banks, in day-to-day liquidity management. Since the maximum maturity of this facility is set at two weeks, it is supposed to be used for very short-term purposes. The second rediscount facility is for relatively longer purposes. In a case of sudden decline in deposits growth, banks will face some difficulty in arranging long-term loan commitments. To help banks avoid potential mismatch, Bank Indonesia provides rediscount services for the duration of

two to four months.

Initially, the Bank Indonesia assumed that these policy facilities would be used for the lender-of-the-last-resort purposes. Maximum access to the two facilities, short-term and long-term, was set to 5 and 3 percent of total deposits, respectively. Combined access of 8 percent of total deposits was allowed. Since the interbank market was expected to grow and open to all deposit banks, the central bank encouraged banks to borrow through the interbank money market. Unfortunately, a severe liquidity shortage in September 1984 was revealed in this market when many banks were reluctant to use the rediscount facility windows because of the central bank attitude concerning these facilities. Immediately after this incident, Bank Indonesia reversed its policy to encourage banks to utilize these facilities. The change was easily apparent, since accessibility of banks to the interbank money market later had to be restricted in October 1984. The imposed ceiling on outstanding borrowings from the market became 7.5 percent of a bank's liabilities. In August 1985, the limit was raised to 15 percent.

Another important development is the appearance of short-term securities issued by the central bank. The Bank Indonesia Debt Certificates (SBIs) were revived for possible use on the open market in February 1984. They were first issued in 1970. However, abundant liquidity created by the oil boom had made the central bank less enthusiastic to promote SBIs. Banks were encouraged to invest excess reserves in foreign assets. As a result, the issuance of the central bank certificates ceased.

The policy change in 1983 deregulated interest rates. This was the end of the administered interest rate system. At the same time, the Bank Indonesia decided not to pay interest on rupiah and foreign exchange reserves. Instead of preferential treatment for bank reserves, to manage the bank liquidity definitely the central bank needs an instrument to absorb or release such a liquidity from banks. Thus, SBIs should be reasonably attractive to banks. An SBIs auction was therefore introduced and FICORINVEST (or Bank Indonesia, if necessary) was put in charge of this dealing. It is hoped that a systematic structure of interest rates in the market will coalesce around the SBI rate. So far, there appears to be no secondary market for SBIs in Indonesia.

Along with active development in the Indonesian money market, the monetary authorities found it necessary to permit money market instruments (SBPUs). The government did not have any reason not to mobilize resources by these in a wider range of markets. Therefore SBPUs were allowed starting in January 1985. These securities are essentially contingent liabilities of the banks or non-bank financial institutions. There are three kinds of SBPUs : first, promissory notes issued by financial institutions ; second, similar notes issued by customers of eligible financial institutions, when they borrow from such customers ; and third, bills of exchange issued by third parties and endorsed by

eligible financial institutions.

SBPUs are rediscountable up to certain limits at FICORINVEST, entitling it to set selling and buying rates for SBPUs of different maturities. Bank Indonesia regulates the eligibility of participants and instruments and also the maximum interest rate from the standpoint of the market quality. So far, the active use of SBPUs has concentrated on the shorter maturity of first type. And state banks are less enthusiastic to utilize SBPUs. These state banks are still accessible to low cost refinancing from the central bank and to low cost deposits from the governmental institutions and public entities. In other words, the SBPU market is very segmented. Nonetheless, the direction of development in the money market seems promising and the financial world generally welcomed this policy. It is too early to make a conclusive judgement concerning effects of these new events at present.

Related to this monetary deregulation, foreign banks, which had been under the severe restricitions, have been permitted to extent export credits with subsidized interest rates to their customers operating outside Jakarta since September 1985. Foreign banks have long requested more freedom of operation in Indonesia. This new development may be a first step in expanding their activities. Similarly, foreign and joint venture companies can receive export credits from state and national private banks. This change corresponds to the major reform in economic policy favoring export promotion.

V Prospects of the Indonesian Financial Sector and Concluding Remarks

As the private industrial sector is expected to grow considerably in the next decade, national private banks will correspondingly have to serve as a crucial promoter of investment. As widely recognized, the banking sector is in a relatively advantageous position for collecting market information and hiring well-trained staff. Generally, it is known that the latter are an extremely scarce resource in Indonesia. In this regard, the banking industry is expected to serve multiple roles such as consultants, marketing and accounting advisors, and even as technical experts. Also, as monetization advances in many regions, the regional development banks are expected to lead regional industrialization. At this present stage, these banks are very fragile in many respects. Nonetheless, in many areas, these banks are probably the largest institutionalized banks. Without their vitality regional growth would not be so promising. In this sense, their role should not be underestimated. In spite of their importance, their relative share in assets and loans has been in significant so far.

In addition, some key open economy variables, which have become major factors in Indonesian macroeconomic performance, need to be carefully analyzed. In this respect, it should be emphasized that the scope of independent monetary policy in Indonesia must be repeatedly questioned. Almost certainly, policy options available

to Indonesian monetary authorities must be chosen in light of external economic conditions.

Generally, policy actions introduced in the 1980s seem to be a right step to strengthen the Indonesian monetary system and economic base. However, it is uncertain whether these new policies will be true effective in realizing the prolonged high economic growth goal. Overall economic policies need to be consistently interwoven. The financial sector is still relatively weak, and excessive expectations may become a burden for it.

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